

Tax-Favored Retirement Funds for Self-Employed

THE NEW Self-Employed Individuals Retirement Act of 1962 (Keogh bill) encourages the nine million self-employed persons—physicians, dentists, lawyers, accountants, farmers, sole proprietors and partners—to establish tax-favored retirement plans for themselves and their employees. The new law makes it possible for retirement plans for the self-employed to have tax benefits similar to those accorded to corporations in connection with Treasury-approved pension plans for employees.

Tax Privilege

A self-employed person whose plan qualifies can make certain current tax deductions for contributions, and the fund and its earnings are exempt from current income tax until the year or years of its distribution. Before this tax-favored status was provided, money invested for retirement was "after tax dollars" and these invested dollars generally had to pay taxes on whatever money the invested fund earned each year.

Who Is Eligible to Benefit from the Act?

A self-employed person is, for the purposes of the act, considered both an employer and an employee. Those who choose to do so may apply to establish a Treasury-approved pension plan. Anyone who performs personal services and receives income for the services he renders, is a self-employed person within the meaning of the act.

Self-Employed Persons With Employees

To be approved, a plan must also cover all full-time employees with three or more years of service. The contributions for employees must be nonforfeitable, at the time they are made.

Contributions for the self-employed person himself cannot discriminate in his favor as compared with contributions he makes for his employees.

Under certain circumstances benefits for covered employees can take into account the Social Security taxes paid by self-employed individuals for their employees.

A full-time employee is one whose customary employment is for more than twenty (20) hours a week and more than five (5) months of the year. Seasonal, temporary and part-time employees are excluded.

Contributions and Deductions

A self-employed individual may contribute for himself each year, \$2,500 or 10 per cent of his "earned income," whichever is less.

There is one exception which applies to a partner

TABLE 1.—Amount Accumulated in Self-Employment Retirement Funds. Comparison With and Without the Benefit of the New Retirement Income Provisions. \$2,500 Contributed Annually. Assume Interest Rate of 4 Per Cent, and Joint Returns.

Years	Under New Provisions	Income Tax Bracket Without Benefit of H.R. 10 (P.L. 87-792)			
		30 Per Cent	40 Per Cent	50 Per Cent	60 Per Cent
		After Taxes			
10.....	\$26,512*	\$24,139	\$22,305	\$20,531	\$18,816
15.....	43,571*	38,930	35,608	32,425	29,405
20.....	63,589*	55,973	50,590	45,558	40,871
25.....	86,665*	75,520	67,464	60,057	53,285

*Note: See column 9, Table 2.

Source: Department of Economic Research, American Medical Association.

who owns 10 per cent or less of a partnership. Such a person is not subject to any limitation on the amount that may be contributed on his behalf under a plan. However, in both instances, the tax deduction allowed is only one-half of the contribution or a maximum of \$1,250.

The full amount of the contribution for covered employees is tax-deductible.

What Is Earned Income?

For a self-employed individual such as a physician, earned income is the net earnings from performing personal services, such as professional fees.

Where both capital investment in a business and personal services are income-producing factors, earned income is assumed to mean 30 per cent of the net profit of the business.

How Do You Start a Retirement Plan?

One who wants to obtain the tax benefits available under the new law must first adopt a written retirement plan of his own or become part of an established plan.

Funding the Contributions

The act provides that contributions can be funded (vested or trustee) in any one of the following ways:

- In custodial accounts with a bank.
- In insurance annuity contracts.
- In trusts—by associations, for example, where investment funds are pooled and the power to direct investments exists.
- In face-amount certificates.
- In special type U. S. Government bonds.

The Internal Revenue Service (IRS) regulations will spell out in some detail how this law may be applied and what arrangements the Service will approve. No final plans can be approved until these regulations are published—probably not before the middle of 1963.

It is clear that an individual plan will be expen-

TABLE 2.—Funds Accumulated by Plans Under H.R. 10. Assumptions: \$2,500 Annual Contribution, 4 Per Cent Interest, Taxpayer Files Joint Return.

Years	(1) \$2,500× 4 Per Cent Factor	(2) Years× \$2,500	(3) Earnings Not Taxed (1)–(2)	(4) Years× \$1,250	(5) Total Not Taxed (3)+(4)	(6) Distri- bution (5)÷5	(7) Joint Returns	(8) Tax (7)×5	(9) Net Fund (1)–(8)
10.....	\$ 30,015	\$25,000	\$ 5,015	\$12,500	\$17,515	\$ 3,503	\$ 700.60	\$ 3,503	\$26,512
15.....	50,059	37,500	12,559	18,750	31,309	6,262	1,297.64	6,488	43,571
20.....	74,445	50,000	24,445	25,000	49,445	9,889	2,171.14	10,856	63,589
25.....	104,115	62,500	41,615	31,250	72,865	14,573	3,491.90	17,460	86,655

Source: Department of Economic Research, American Medical Association.

sive and cumbersome. Banks and trust companies will devise group custodial plans which will be available at rather minimal cost. Insurance companies will present many funded retirement proposals. The special U. S. Government bonds will be readily available for all those who choose them.

Under a somewhat similar law, the Canadian Medical Association several years ago developed for its members a very flexible trust fund. Insurance coverage is available, as well as investment in stocks, bonds, mutual funds and other investments. Under such a plan, each member can direct how he wants his contributions to be invested and he may change his plan from time to time. The California Medical Association has established a committee to investigate all possibilities and to recommend the most favorable and flexible plan that can be devised. Since a broad base offers many savings, it was concluded that all county medical societies would benefit by a uniform statewide inquiry to develop standards and programs best suited to the need of all physicians.

How Are Benefits Paid?

Payment of benefits to the self-employed person under a plan cannot begin until he reaches age 59½, unless he is permanently disabled earlier. Benefits are also payable to his beneficiary at his death or within five years after his death. Payments must begin no later than age 70½.

Benefits from the plan are taxable as ordinary income if paid out during the lifetime of the primary beneficiary and during the lifetime of a surviving wife if joint survivorship has been provided for in the plan.

If premature distribution of benefits occurs for any reason other than permanent disability, a tax penalty must be paid.

Lump Sum Distribution

Although a self-employed person cannot get capital gain treatment on a lump sum distribution, an averaging method of computing the tax is used

which may make the tax come to substantially less than the tax on ordinary income. Contributions for which no tax deductibility was allowed at the time they were made, are excluded from the taxable portion of benefits distributed.

Covered employees of the self-employed are entitled to the same capital gains privilege on lump sum distribution as employees under corporate plans—a maximum of 25 per cent on the amount received.

Comparison of Benefits That May Be Accumulated With and Without Use of the New Law

Tables 1 and 2 were prepared by the A.M.A. Department of Economic Research to illustrate the way in which this law may help a physician plan a tax-sheltered retirement fund.

Is It Necessary to Establish a Plan at Once?

No. As a matter of fact, no plan can be approved by the IRS until the regulations are published.

A plan may be established and contributions made at any time before December 31, 1963 and have the contributions receive tax benefits for 1963.

Each person will have to study the various plans available to determine what tax advantages exist, if any, for him. It would appear that this first tax law for the self-employed may not be as helpful for some as it is for others.

It may reasonably be assumed that in the years ahead this law will be improved. It has been referred to as the most important tax break ever given to the self-employed. It does provide incentives for self-employed persons to participate in tax-deferred retirement plans for themselves and their employees.

Many corporations have found, through experience, that the establishment of retirement plans has been an incentive for talented people to seek employment with them and remain with the organization. It has materially assisted in reducing the turnover of employees, which is usually very costly to any employer.